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TO NEW REALITY WHILE SME'S STRUGGLE FOR CREDIT

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¶B. BUDAPEST 1139
¶C. BUDAPEST 1059

¶1. (SBU) Summary. The banking industry is undergoing a rapid transformation as the financial crisis and global credit crunch impose new realities on the financial sector in Hungary. Banks find themselves altering their business models to reduce loan deposit ratios and improve the quality of their loan portfolios. The government, meanwhile, is rushing to pump liquidity into the system even as it tightens its oversight of the industry. Small businesses, a key political constituency but viewed as riskier and less profitable than consumer borrowers, are increasingly finding themselves caught in the middle and without access to credit. End summary.

PARLIAMENT PASSES REVISED BANKING ASSISTANCE PACKAGE

¶2. (U) On December 15, the Parliament passed a revised version of its banking sector support package, part of the Stand-by Arrangement with the IMF. The package includes a fund to guarantee the rollover of loans and wholesale securities (Liquidity Fund), and a fund to increase the capital of banks (Capital Enhancement Fund) (ref A). The revised law expands the number of banks eligible to participate in the program, and addresses a key concern of banks by limiting the possibility of the government taking over management and control of participating institutions.

¶3. (U) Participation eligibility in the HUF 600 billion (USD 3 billion) package has also been expanded. Under the initial draft proposal, only three banks met the warranty capital requirements. This has now been expanded to all credit institutions registered in Hungary.

¶4. (U) Banks are in the process of studying the new law, and have not yet indicated whether they will use the support package. Many observers believe that a number of banks will likely use the credit guarantee program, if not the Capital Enhancement Fund.

¶5. (U) The IMF welcomed legislation implementing the banking assistance package in its recent review of economic and fiscal developments in Hungary, noting that with current global deleveraging and economic downturn, "it is important that banks in Hungary have access to the same capital enhancement and borrowing guarantees as other banks in the EU."

GREATER GOVERNMENT OVERSIGHT

¶6. (U) Additional support for the financial sector will be accompanied, however, by additional regulation and oversight.

As noted in its agreement with the IMF, the government is working on legislation to strengthen financial sector regulation and supervision, including expanding the role of the financial supervisory authority to more actively monitor and analyze risks to the financial sector, and to provide it with additional tools to intervene if necessary. Other measures announced in the IMF agreement include the introduction of a positive credit registry for households, introduction of maximum loan-to-value ratio requirements for new mortgage loans, and close monitoring of foreign exchange exposures.

SME LENDING HURT BY LOWER LOAN DEPOSIT RATIOS, FOCUS ON PROFITIBILITY

¶7. (SBU) A number of bankers have told us that the financial crisis is rapidly transforming the banking sector in Hungary. Over much of the last decade, banks enjoyed high levels of profitability, and were focused primarily on growth and increasing market share. Today the landscape has changed considerably, as scarce and more expensive credit and greater oversight from parent banks is causing banks to focus on improving the quality of their loan portfolios, reducing loan deposit ratios, and shedding less profitable business lines. Unfortunately, small and medium sized enterprises (SMEs) will likely feel the worst effects of these changes.

LOWER LOAN DEPOSIT RATIOS

¶8. (SBU) Banks in Hungary maintain comparatively high loan deposit ratios. In June 2008, the loan deposit ratios of large banks in Hungary averaged nearly 150 percent, with only

one major bank having a loan deposit ratio below 100 percent. When loans exceed deposits, banks must rely on parents or external sources of funding to cover excess liabilities. Because of continued scarce and expensive credit, and possibly instructions from parent banks, banks are reducing their loan deposit ratios to levels more sustainable in the current environment.

¶9. (U) To do so, banks are working hard to increase deposits on one hand, and are limiting new loans and not renewing certain existing loans on the other. To increase deposits, banks are offering high interest rates as a lure to depositors. K&H Bank, for example, is currently offering interest rates of over 13 percent for certain deposits (the Central Bank benchmark is currently 10.5 percent). Other banks are offering similarly high rates.

¶10. (SBU) Their efforts appear to be taking affect, but perhaps in unanticipated ways. The Central Bank reports that deposits from companies into Euro-denominated accounts rose over 50 percent in June - October, climbing over HUF 1.4 billion. By contrast, HUF-denominated deposits dropped 4 percent to HUF 1.6 billion.

¶11. (SBU) Banks are also reportedly tightening lending standards and reducing the number of riskier and less profitable loans in their portfolios in order to both reduce loan deposit ratios and to improve the quality of their loan portfolios. Consumer lending, while experiencing some decline, has not been severely impacted, as it is generally favored over corporate lending because of higher profit margins and more diffuse risk. Unicredit officials tell us that international institutions find these operations in Hungary particularly profitable compared to other European markets. In the corporate sector, banks favor large corporate customers over smaller businesses, which are often viewed as riskier and which generally have lower profit margins.

¶12. (SBU) As a result, SME's are facing difficult times securing financing. Gyorgy Barcza of K&H Bank predicts that unless the government takes action or liquidity returns to

the market at pre-crisis levels, we will see an increasing number of small businesses fail because they are unable to obtain new financing or renew existing loans. Indeed, we are already hearing anecdotal evidence of this from business contacts (ref B). SzDSz Party President Gabor Fodor, for example, told a group of Ambassadors yesterday that he found "most stores empty ... or not open at all" when he tried to do his Christmas shopping.

PROVIDING CREDIT TO SME'S

¶13. (SBU) The Hungarian government and international institutions recognize the problem and are working to increase liquidity in the banking sector, with a particular focus on SME's. Central Bank Governor Andras Simor reports that about HUF 1,000 billion (USD 5 billion) more liquidity flowed into the Hungarian banking system in the last quarter than the previous one, as the mandatory reserve requirement was lowered from 5 to 2 percent, and banks found new funding sources. Despite increased liquidity, however, Simor notes that banks remain risk averse, and are "not getting money out the door," particularly to SME's.

¶14. (SBU) Simor believes additional measures are needed to incentivize banks to use resources where they are most useful. He admits that this is not ordinarily the role of a central bank, and that banks should make loans based on their own business decisions, but notes that "these are not normal times."

¶15. (U) The government has already undertaken steps to encourage loans to small businesses (ref C), including through micro-credit programs, redirecting EU development funds to SMEs, and providing financial incentives and loan guarantees to banks. In addition, the EBRD and the EIB are making more money available to banks for SME's.

¶16. (SBU) Comment. Despite statements from banks and government officials that the banking sector in Hungary "isn't broken", the financial crisis and current economic situation is transforming several aspects of the Hungarian banking industry. For banks, the order of the day is to improve the quality of loan portfolios, reduce vulnerabilities, and shed less profitable business lines. On

the government side, the trend is toward greater regulation and oversight of the financial sector and toward greater sensitivity to SME's, which represent a large political base depite their comparatively modest economic impact. At the end of the day, these trends may result in a healthier, less vulnerable financial sector. In the short term, however, there is a risk that it could further delay the financial sector "returning to normal", and could have increasing spillover effects on the real economy. End comment.
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